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Adaptability, Accountability and Sustainability: Intergovernmental Fiscal Arrangements in Canada

Ever-rising federal transfers to provinces weaken accountability and fiscal discipline. Greater provincial reliance on their own revenue sources would strengthen the federation over the long term.

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The Study In Brief

In recent years, transfers from the federal government to provinces, territories and local governments have grown rapidly. They now account for about one-fifth of the revenues of those governments, and about one-third of federal program spending.

Central governments in federations typically raise more than they need to fund the programs and services they provide directly, and sub-central governments typically raise less than they need. But when these gaps, and the transfers that bridge them, are large, the fundamental federal principle that governments at each level are sovereign in their respective spheres gets strained.

While transfers can, in principle, help achieve national-scale public goods, address spillovers among provinces, and support minimum standards for public services and other programs across the country, Canada's past and present system does not consistently reflect these purposes. On the downside, their potential to undermine accountability and induce unsustainable fiscal policies means Canadians should be cautious about assuming that expanding transfers further will have good effects.

Looking ahead, pressure to expand federal transfers to provincial governments seems likely. Demographic change will damp the growth of government revenues in Canada, and put upward pressure on program spending, particularly at the provincial level. Responding effectively to this pressure will require a mix of tax increases and spending restraint from provinces, and ideally some partial prefunding of programs such as pharmacare and long-term care. Such reforms are likelier if the federal government limits growth in intergovernmental transfers, and reduces its tax take, in consumption taxes for example, so as to make more tax room available to the provinces.

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Amounts spent and raised by different levels of government in Canada have never coincided: the federal government has always raised more, and provincial, territorial and local governments less, than required for their own programs.

Accordingly, transfers from the federal government to other levels of government have been a feature of Canadian fiscal policy since Confederation.[1]

Initially modest relative to Canada's economy, intergovernmental transfers grew as the role of governments in providing services and redistributing income grew through the 20th century. They now occupy a major place in the budgets of Canadian governments: about one-third of the spending of the federal government, and almost one-fifth of the revenues of recipient governments. They are correspondingly prominent in public and official discussions. The 2015 federal budget devoted 11 pages to a survey of intergovernmental transfers and federal/provincial spending and taxing powers, and most provincial budgets devoted considerable attention to the topic.

Transfers from central to sub-central governments are common throughout the world. Because they are particularly visible in federations, scholars and other commentators in federations, including Canada, have been prominent in elaborating possible justifications for divisions of taxing and spending powers, and for intergovernmental transfers for various purposes, including closing any fiscal gaps a particular division of powers creates. That literature naturally responded to the circumstances, including the specific mixes of taxes, programs and transfers, that prevailed at the time. As a result, positive observations about what was happening have tended to be tightly interwoven with normative statements about what should be.

This *Commentary* begins by describing the history that shaped Canada's current system, then reviews various insights about potential uses of federal-provincial transfers and comments on the degree to which they justify current practices. It next describes potential future evolutions of spending and revenue at the federal and provincial levels. It closes with some comments on how different types of intergovernmental transfers may affect the efficiency, accountability and sustainability of Canadian fiscal policies and major programs.

An important theme in this survey is the fact just mentioned: that particular circumstances, including fiscal stresses at either level of government, and the political responses to those circumstances, have been central in shaping Canada's arrangements. Notwithstanding the insights from public economics about how intergovernmental transfers can address externalities within a federation and provide public goods on a national scale, nothing

We thank Colin Busby, Finn Poschmann and Daniel Schwanen, and several anonymous reviewers for comments on earlier drafts, and also thank Colin Busby and Aaron Jacobs for collaboration on key sections of this paper. Responsibility for any remaining errors and for the views expressed is ours alone.

1 Our principal focus is relations and transfers between Canada's senior, sovereign governments: federal and provincial. We treat federal transfers to local governments – which are, in a traditional phrase "creatures of the provinces" – as part of federal-provincial transfers. We note instances where the data we cite also include transfers to the territories, which are wards of the federal government but in some respects function like provinces.

in economic logic dictates that the gap between revenue and spending at the federal and provincial levels should be as large as it now is in Canada, nor that the gap must grow as it has done, nor that the transfers that bridge it should be structured along current lines.

A second key theme is that the key principle that federal and provincial governments are sovereign in their respective spheres coexists uneasily with federal-provincial transfers, especially when they are large and complex. A focus on the provincial autonomy that is desirable in a federation, as well as on responding effectively to challenges at each level of government, and limiting potentially adverse influences of intergovernmental transfers on budgetary policy, would point toward smaller, simpler intergovernmental transfers. We see a strong case for more closely aligning the revenue-raising and spending powers of governments at each level.

The History and Current State of Intergovernmental Transfers in Canada

Canada's division of revenue and spending powers between the senior governments, and the transfers that reconcile gaps between revenue and spending at each level, have evolved in response to changing concerns and political pressures.

The 19th Century

As is well known, the *British North America Act* – now formally termed the *Constitution Act, 1867* – and key political and legal decisions shortly after Confederation gave Canada a system in which the federal and provincial governments are sovereign in their respective spheres.

Looking first at responsibilities, some powers, notably those related to defence, money and banking, navigation, Indians, immigration and criminal law, became federal matters. Others, notably those related to property and civil rights, natural resources,[2] municipalities, charities and services now generally referred to as healthcare and education, became provincial matters.[3]

As for the resources to finance those responsibilities, the 1867 *Act* granted the federal government power to implement "any mode or system of taxation."[4] It granted the provinces "direct taxation within the province"[5] – a formulation intended partly to preclude tariffs on interprovincial trade, and which has been interpreted so elastically as to allow a variety of indirect taxes. As a result, the tax bases of the federal and provincial governments largely overlap. Both levels have legally unlimited power to borrow to finance any activity.

By today's standards, late 19th-century government spending was small relative to the economy. In peacetime, federal infrastructure – such as the national railway and other projects providing benefits on a national scale – was expected to dominate government spending. The indirect taxes – customs, duties, and fees – that then provided the bulk of revenues were also federal, and accounted for about 80 percent of all government revenues (Hogg 1997).

2 In keeping with the theme of specific circumstances trumping general principles, we note that Alberta and Saskatchewan did not gain control of their sub-soil resources when they became provinces.

3 See sections 91-95 for the complete description of provincial and federal legislative powers. Available at http://laws-lois.justice.gc.ca/eng/const/page-4.html#h-17

4 *Constitution Act*, 1867, Sec. 91(3).

5 *Constitution Act*, 1867, Sec. 92(2).

Responding to arguments that the provinces' revenue-raising capacity, largely dependent on property taxes from relatively rural populations, was inadequate to finance their responsibilities, the 1867 *Act* provided for transfers from the federal government. Originally, these included funding for public administration as well as per capita transfers to reduce regional disparities. In addition, these transfers contained an incentive to control public debt.[6]

The federal transfers were originally fixed total sums or fixed dollar amounts per head. So growth of the economy and government budgets had reduced their importance in provincial revenues by the end of the century. From nearly 6 in 10 dollars of provincial revenue in 1874, federal transfers had fallen closer to 4 in 10 dollars by 1896 (Perry 1997).

The 20th Century

Federal and provincial spending and revenues changed markedly over the course of the 20th century.

Two world wars created a need, and demonstrated a capacity, for governments to mobilize resources on a much larger scale. The 19th-century model of relatively small governments mainly providing infrastructure and internal and external security transitioned to the post-Second World War welfare state. By the end of the century, healthcare, education and social services – areas of provincial responsibility – had become major government programs in Canada, as in other developed democracies.

On the revenue side, Ottawa introduced personal and corporate income taxes in stages during the First World War. Many provinces started taxing corporate and personal incomes for the first time in the 1930s to finance the needs of the Great Depression. Concerns about the complicated structure of taxes going into the Second World War, and then the fiscal stresses of the war itself, produced important changes in income taxes. Under "tax rental agreements," the provinces vacated the personal and corporate income tax fields in return for federal transfers. After the war, tax collection agreements supplanted the tax rental agreements. Provinces progressively regained tax-policy autonomy, as long as they conformed to shared definitions of the base for taxable income. As provincial spending responsibilities grew, the provincial share of personal income tax revenues increased. One formal change in tax fields occurred in 1980, when the federal government vacated the lottery and gaming field in return for an annual payment from the provinces (Desjardins et al. 2012).

As revenue and spending arrangements changed, intergovernmental transfers changed too. Notably, federal transfers became more incentivizing. An early example was a federal subsidy for technical education during the First World War. In 1927, long before the 1951 constitutional amendment that made old-age income supports become a federal responsibility, Ottawa began paying half their cost. The Great Depression tested many provinces' access to credit, with Alberta defaulting in 1936. The federal government's superior access to credit, backed after the creation of the Bank of Canada by the power to monetize debt, increased its attractiveness as a subsidizer of provincial programs. In particular, Ottawa provided extensive supports for the unemployed, before the transfer of responsibility for unemployment insurance to the federal government in 1940.

6 *Constitution Act*, 1867 Sec. 112, 114-116, 118, 119.

During the late 1950s and 1960s, the appeal of federal support for national social programs was strong in most parts of the country, and rapid growth in the economy and federal revenues made relatively open-ended support of provincial programs seem affordable. Federal payments geared to half of aggregate provincial spending on publicly funded doctor and hospital care developed during those years. Ottawa replaced direct grants to universities with transfers to provincial governments, likewise geared to half of aggregate provincial spending on post-secondary education. Ottawa also supported provincial welfare programs through the Canada Assistance Plan (CAP), which underwrote half of relevant expenditures in each province individually.[7]

An exception to this general move toward conditional grants was the 1957 establishment of a formal Equalization program. Equalization's essence is to top up the revenues of provinces with lower-yielding tax bases.[8] The representative tax base used to determine Equalization entitlements changed several times in later decades, reflecting a variety of tensions as the fortunes of specific provinces rose and fell, and as the federal government found its obligations under the program easier or harder to meet.

Another notable exception to the general narrative of federal inducements to provinces to expand their programs by subsidizing them was Ottawa's offers, in 1964, and again in 1968 and 1973, to withdraw from certain cost-shared programs and transfer tax room to the provinces instead. (At that time, provincial income taxes – with the exception of Quebec – were computed as percentages of federal income taxes, which gave rise to the terminology of "tax points" – each percentage point being one tax point.) Most provinces preferred the shared-cost subsidies; only Quebec accepted the federal offer. Since 1965, Quebec taxpayers have received a special "tax abatement" in lieu of cash transfers Ottawa would otherwise have made.[9]

The end of the rapid growth of the 1950s, 1960s and early 1970s put the federal budget under pressure, and prompted changes to federal grants in support of healthcare and post-secondary education. New Established Program Financing (EPF) arrangements replaced cost-sharing arrangements with a formal transfer of tax base ("tax points") and a cash transfer. These changes reduced federal subsidization and exposure to provincial spending decisions: no longer were the provinces collectively spending "50 cent dollars" on these programs.[10] To make its leverage over provincial healthcare policy more explicit, the federal government passed the *Canada Health Act* in 1984, providing a formal basis for reduced transfers to provinces that did not adhere to its principles.

7 This activity, not explicitly anticipated in the constitution, was justified by a federal 'spending power' inferred from sections 91(3), 91(1A), and 106. See Hogg (1997).

8 *The Constitution Act*, 1982 included a commitment in section 36(2) as a transfer to provinces for providing services "at reasonably comparable levels of taxation," created a constitutional basis for equalization payments to provinces and, arguably, for other major transfers as well.

9 The abatement, originally set at 23 percent of federal personal tax revenue, has since been reduced to 16.5 percent on account of changes to federal programs over the years.

10 For clarity, the EPF transfer was calculated with reference to aggregate provincial spending, so no single province enjoyed a 50 percent subsidy. The CAP transfers continued to be calculated with reference to individual provincial spending, continuing to create 50 percent subsidies for all.

Ottawa's fiscal problems intensified during the 1980s, and the economic downturn of the early 1990s pushed its deficit and debt up the national agenda. The mid-1990s effort to balance the federal budget had a major impact on intergovernmental transfers. Ottawa first capped its CAP subsidies to several provinces. It then combined grants for healthcare and post-secondary education with the Canada Assistance Plan in one block fund, the Canada Health and Social Transfer (CHST), eliminating the last of the "50 cent dollars" provinces had been spending on welfare programs. The total CHST was initially smaller than its predecessor programs – part of Ottawa's effort to eliminate chronic deficits.

These changes were a rude shock to the provinces. After increasing in line with the economy in the early 1990s (Figure 1), federal transfers fell sharply in 1996/97 and 1997/98. Although they grew again as Ottawa's budgetary situation improved, provincial governments and other advocates were complaining of a "fiscal imbalance" as the 20th century drew to a close.

The 21st Century

In the early 21st century, the formal structures of spending and revenue-raising, and the intergovernmental transfers that bridge the gaps between spending and revenue, have changed relatively little, but the dollar amounts have changed markedly. In the 20 years from the early 1990s to the early 2010s, provincial, territorial, and local (PTL) governments increased their share of consolidated government spending – excluding intergovernmental transfers – from 63 to 72 percent. They also increased their share of revenue: looking at own-source revenues – that is, excluding intergovernmental transfers – from 56 to 60 percent (Figure 2).

Program Spending by Types

At present, and going a layer deeper, PTL governments currently make about 85 percent of expenditures on operations – payments to employees, contractors, utilities, and so on – reflecting their role as public service providers. PTL governments also manage about 85 percent of public infrastructure expenses, and hand out about 80 cents per dollar of business subsidies (Figure 3).

Ottawa continues to dominate transfer payments to households through employment insurance, benefits for seniors and families with children, and other purposes. About 70 cents of all government payments to individuals are now federal.

Revenues by Tax Bases

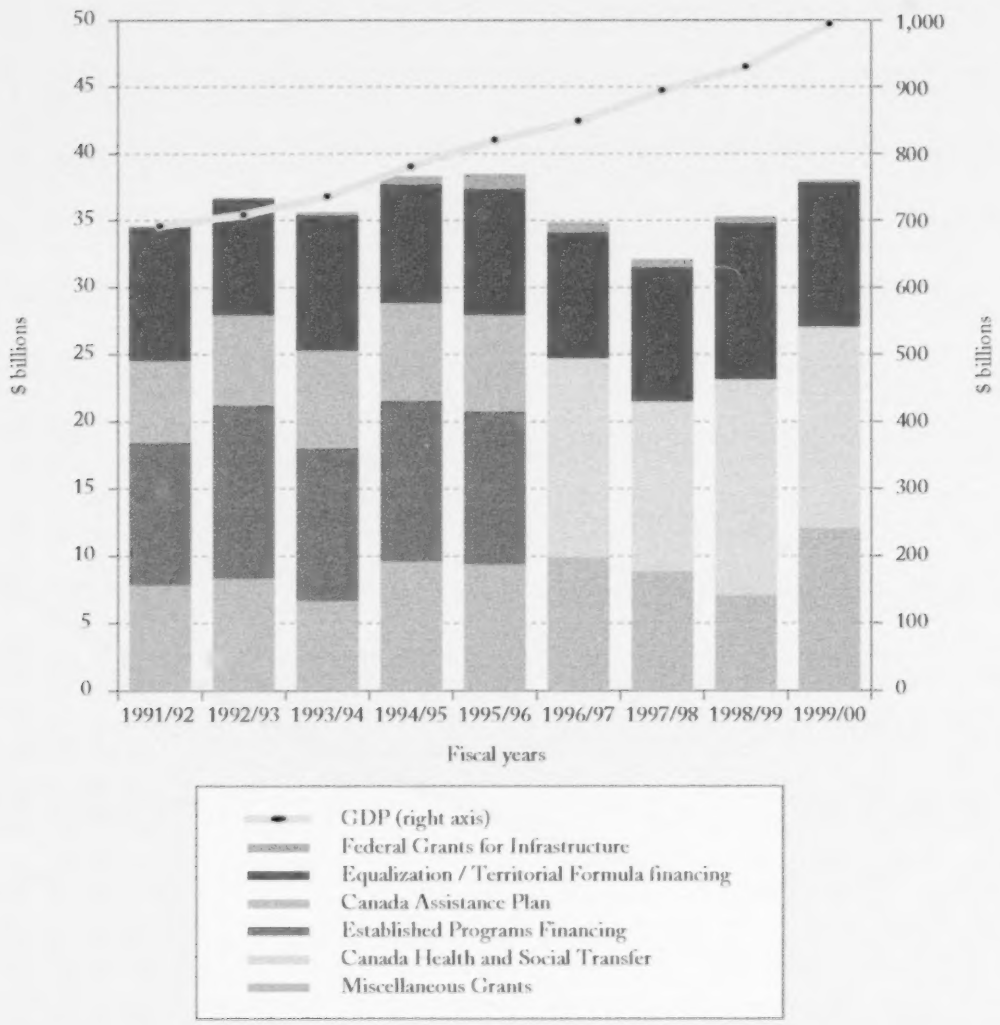
Turning to revenues (Figure 4), property taxes continue to raise a substantial amount of provincial revenue. By contrast, Ottawa's exclusive jurisdiction over customs and other levies on international trade and transactions has become less important as international trade has become freer.

As for shared tax fields, Ottawa is still the largest collector of personal and corporate income taxes, raising about two-thirds of the total. The provinces collect about two-thirds of consumption tax revenues, up markedly over the last 20 years, thanks to rate cuts at the federal level and rate increases at the provincial level.

Miscellaneous non-tax revenues – mainly investment incomes, profits of government business enterprises, royalties, user fees, fines and other penalties, asset sales, and various other sources – are important for PTL governments. The federal government collected only about one-eighth of such revenues in 2014.

Contributions to social insurance schemes and provincial payroll taxes that flow into consolidated

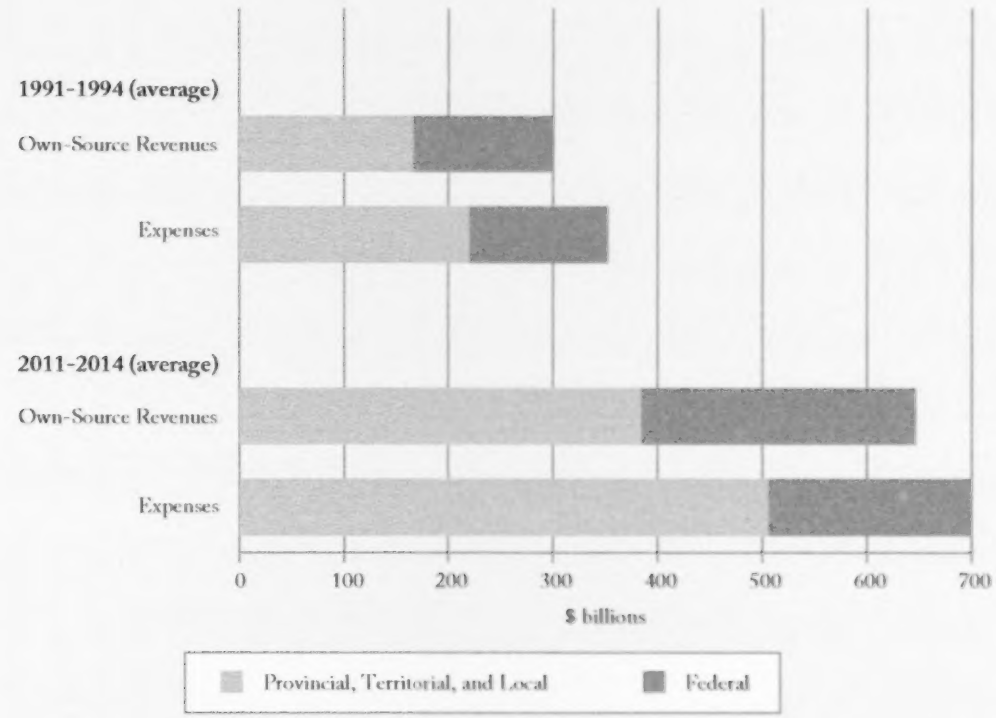
Figure 1: Federal Transfers to PTL Governments, by Major Category, 1991/02 to 1999/00



Note: Data adjusted to take into account of the effect of the Quebec tax abatement: federal cash transfers to Quebec are increased by the value of federal income tax abated under the Alternative Payments for Standing Programs (13.5 tax points).

Sources: Government Finance Statistics (Statistics Canada 2015), Public Accounts of Canada (RCG various years), and Canada (2015); authors' calculations.

Figure 2: Consolidated Revenues and Spending by Levels of Government (Excludes Intergovernmental Transfers), 1991-1994 and 2011-2014



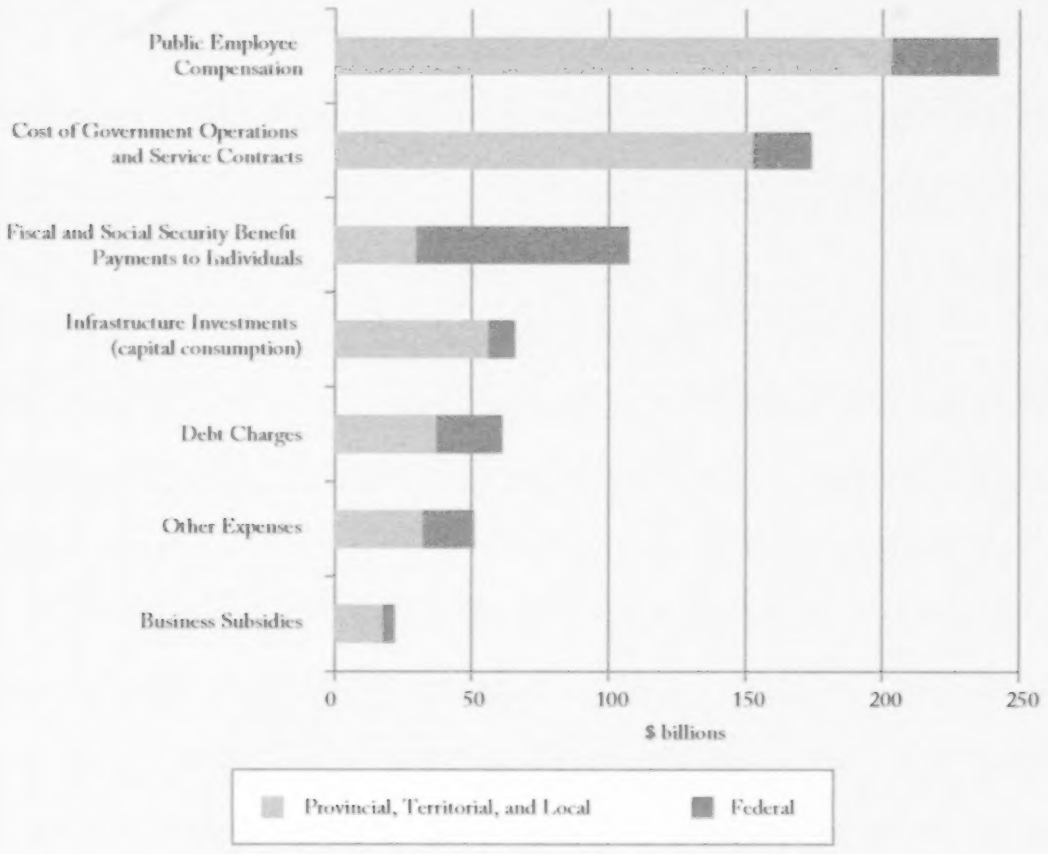
Note: Data adjusted to take into account the effect of the Quebec tax abatement: Quebec tax revenues are reduced by the value of federal income tax abated under the Alternative Payments for Standing Programs (13.5 tax points) and the discontinued Youth Allowances Program (3.0 tax points); federal revenues are increased by the same amount.

Sources: Government Finance Statistics (Statistics Canada 2015); authors' calculations.

revenue[11] now yield roughly equal amounts to each level. Ottawa has recently collected something less than two-thirds of contributions to social insurance schemes related to employment, workplace injuries and healthcare, down from more than three-quarters in the early 90s. This change reflects slower growth in federal employment insurance payouts and revenues than in provincial workers' compensation and drug programs.

11 The largest being the Quebec Health Services Fund Contributions and the Ontario Employer Health Tax.

Figure 3: Government Spending at Federal and PTL Levels, by Category, 2014



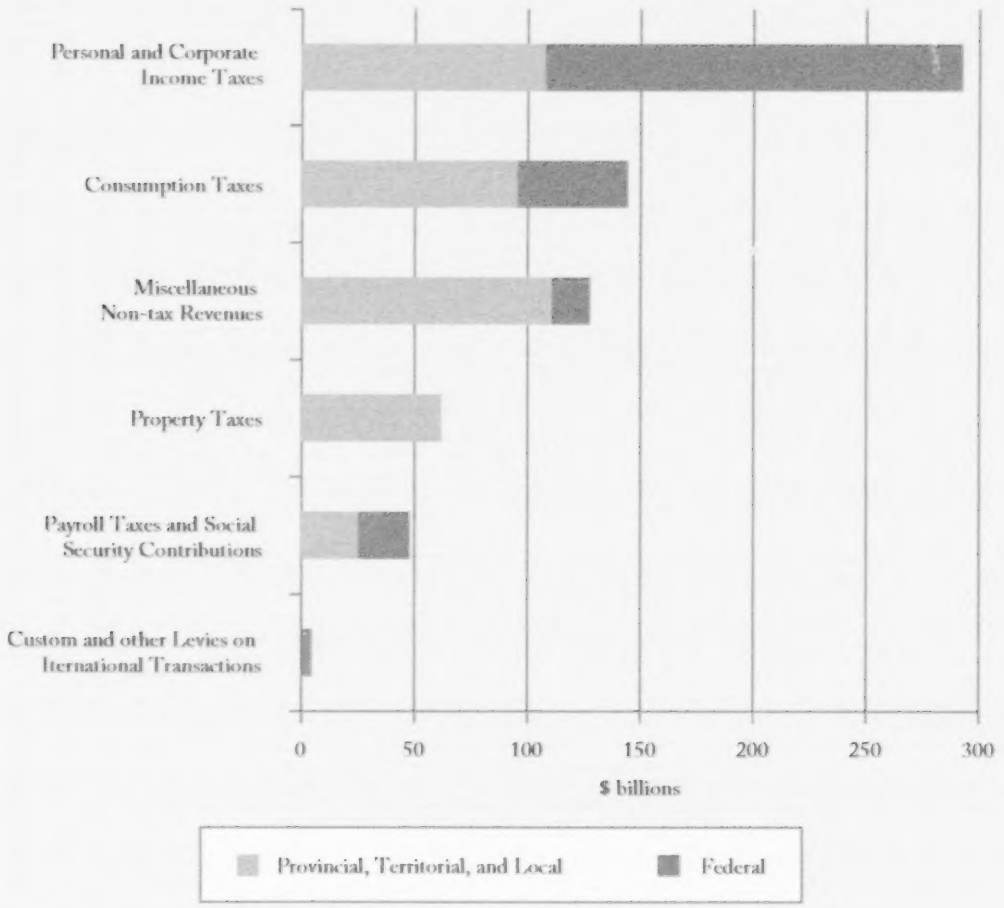
Sources: Government Finance Statistics (Statistics Canada 2015); authors' calculations.

Intergovernmental Transfers

The fact that provinces have increased their share of spending more than their share of own-source revenues since the 1990s implies that federal transfers have increased and/or that their budget balances have deteriorated relative to the federal balance. Both are true.

Improved federal fiscal health and pressure for larger transfers spurred faster growth in payments after 2004. Ottawa split the CHST into a Canada Social Transfer (CST) and a Canada Health Transfer (CHT). The former continued to grow with the economy, but the latter – responding to the higher public profile of healthcare spending –

Figure 4: Government Revenues at Federal and PTL Levels, by Category, 2014

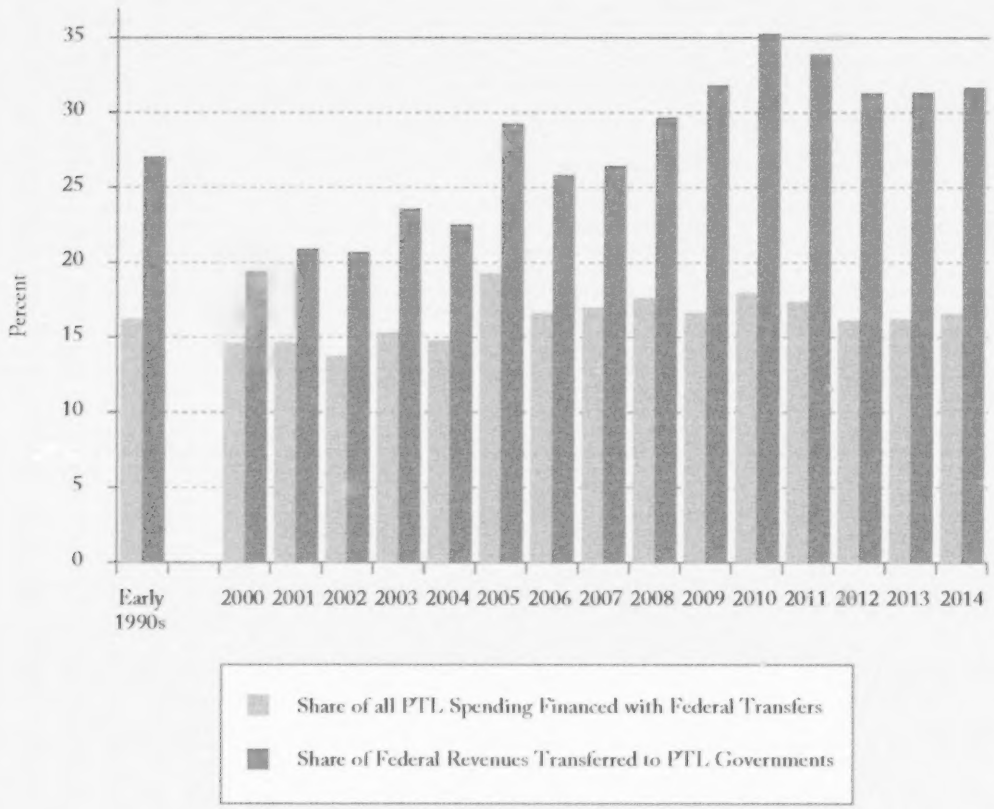


Note: Data adjusted to take into account the effect of the Quebec tax abatement: Quebec tax revenues are reduced by the value of federal income tax abated under the Alternative Payments for Standing Programs (13.5 tax points) and the discontinued Youth Allowances Program (3.0 tax points); federal tax revenues are increased by the same amount.

Sources: Government Finance Statistics (Statistics Canada 2015); authors' calculations.

grew faster. The net result was that federal transfers outpaced GDP. They also rose relative to PTL spending, from about 15 percent after the cuts of the late 1990s to around 17 percent recently. And they rose relative to Ottawa's resources: roughly one in three dollars raised by federal taxes recently has financed intergovernmental transfers (Figure 5).

Figure 5: Federal Transfers Relative to PTL Spending and Federal Revenue



Note: Data adjusted to take into account the effect of the Quebec tax abatement: federal revenues are increased by the value of federal income tax abated under the Alternative Payments for Standing Programs (13.5 tax points), whereas federal cash transfers to Quebec are increased by the same value. "Early 1990s" represents the average of years 1991 to 1994.

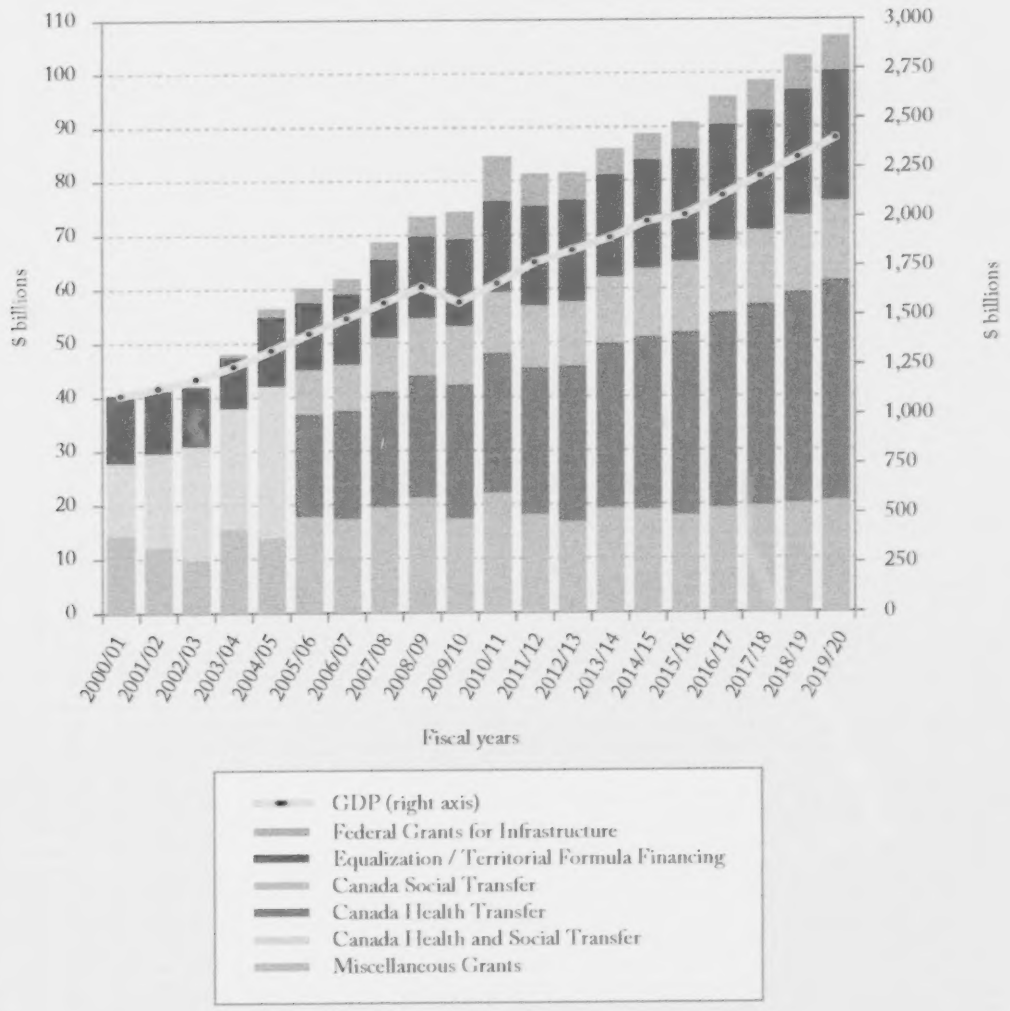
Sources: Government Finance Statistics (Statistics Canada 2015); authors' calculations.

Current Transfers and Commitments

That account brings us to the present, and a review of the current configuration of transfers and their likely growth.

The largest single intergovernmental transfer is the CHT – $32 billion in 2014/15, expected to grow to $41 billion in 2019/20. The CST is also sizeable – $13 billion in 2014/15, expected to reach $15 billion in 2019/20 (Figure 6). The CHT is legislated to continue its 6 percent annual escalation until the 2016/17 fiscal year, and thereafter to increase at least 3 percent annually up to the rate of growth of the economy. The CST is legislated to continue its 3 percent annual growth.

Figure 6: Federal Transfers to Other Governments, by Major Category, 2000/01 to 2019/20



Note: Data adjusted to take into account the effect of the Quebec tax abatement: federal cash transfers to Quebec are increased by the value of federal income tax abated under the Alternative Payments for Standing Programs (13.5 tax points).
Sources: Government Finance Statistics (Statistics Canada 2015), Public Accounts of Canada (RCG various years), and Canada (2015); authors' calculations.

The CHT and the CST, paid on a per capita basis, are formally earmarked to support provincial spending on healthcare, post-secondary education, child care, social assistance, and other social services. In practical terms, however, they resemble unconditional transfers. The money is fungible and can help provinces spend on anything, provide tax relief, or improve their budget balances. There are no recent instances of Ottawa withholding payments to penalize a province for deficiencies in its programs.

Rounding out the three largest transfers are the Equalization and the Territorial Formula Financing (TFF) programs – a combined $20 billion in 2014/15, expected to reach $24 billion in 2019/20. The Equalization formula reflects differing yields of tax bases among provinces; TFF reflects differing tax yields among all 13 jurisdictions. A desire to create a predictable obligation has led Ottawa to gear total Equalization payments to GDP since 2009.

Alongside these programs, Ottawa transfers several billion dollars annually for public infrastructure, largely through the Gas Tax Fund, the Goods and Services Tax Rebate for Municipalities, and the "Building Canada Plan." Infrastructure grants amounted to a few hundred million dollars per year up to the mid-2000s, when they increased rapidly (Figure 6). With the $1 billion annual grant for public transit committed in Budget 2015, federal infrastructure grants are scheduled to reach about $7 billion per year by 2023/24.

The major transfers and infrastructure grants just described make up about 80 percent Ottawa's transfers to other governments. The remaining grants are for a host of specific purposes, among them the Canada Quebec Accord on Immigration, Wait Time Reduction Transfers, payments to provinces regarding sales tax harmonization and payments under Canada Job Fund Agreements.

Theories of Federalism and Intergovernmental Transfers

Canada's historical and current division of revenue and spending powers, and intergovernmental transfers, was not primarily guided by formal theories of federalism. Economists and others have, however, illuminated forces driving the evolution of federal systems, including Canada's. We now turn to those – drawing insights from public economics about important goals that fiscal federalism can help achieve, and about the implications of practices that have evolved for other reasons.

Subsidiarity and the Case for Provincial/Local Government

It helps to start by asking why Canada, or any country, has more than one government. The high-level answer is that sub-central governments are better providers of many things people want. The division of powers at Confederation reflected a desire among many of the new country's citizens' for provincial management of numerous things they wanted governments to do.

The case for sub-central provision and regulation is stronger when sub-central tastes and conditions vary. In Canada's case, differences in language, religion and much else resulted in a federation that was less centralized than some founders wished, with the realities of negotiation among entities that could have remained separate if they chose making the desire for provincial control highly influential.

In a democracy with freedom of movement, organizing public affairs at the most decentralized, competent level – a principle often referred to as "subsidiarity" – has a key further feature. People can move among jurisdictions in response to differences in government programs and taxes. An influential early exploration of these dynamics by Charles Tiebout (1956) described how competition among sub-central governments levying taxes on their

residents that are akin to prices for the programs they provide, can foster efficient provision of public goods and services. Residents of one jurisdiction who prefer the benefits provided and prices charged by another one can move there, so people of differing tastes can locate in jurisdictions that suit them better.

A complementary dynamic noted by scholars who emphasize incentives and self-interest in the public sector – generally known as the "public choice" school – is that competition among jurisdictions can protect citizens from people in, and interest groups working through, government who seek to benefit themselves (see, for example, Brennan and Buchanan 1980). This view sees horizontal competition among sub-central jurisdictions, as well as vertical competition between the two levels of government, as a spur to accountability, more efficient services, and a support for democratic government more generally.

National Interests and the Case for Federal Programs and Taxation

What, then, determines what gets done at a central level? Classical public economics – a large part of what Oates (2005) terms "First Generation Theory" of fiscal federalism – tended to stress four broad categories of reasons for assigning functions to the central government in a federation: externalities, different scales for the provision of different public goods, regional redistribution to achieve certain standards of public services and other programs, and mitigating potentially harmful internal migration.

An uncontroversial example is defence against external aggression: a public good primarily organized on a national scale. Others are major elements of international trade and immigration. In countries with small pools of talent suitable for public administration, the central government may have an advantage in delivering services (as argued, for example, by Prud'homme 1994) – though, happily, we think this argument has limited applicability to Canada.

On the economic front, most major countries give central governments exclusive control of currency and related financial regulation. Because monetary policy and fiscal policy are both tools of macroeconomic management, moreover, a substantial central-government capacity to tax, spend and borrow is widely seen as helpful in counter-cyclical demand-management.[12] A similar argument supports central-government responsibility for insurance against unemployment, more effectively pooling risk across sectors, and over time.

Public-Finance Rationales for Intergovernmental Transfers

If subsidiarity alone dictated assignments of responsibility among different levels of government, locating responsibilities at the lowest level with the competence to discharge them and assuring that each level financed its own activities would make sense. Accountability at the sub-central level would spur sub-central governments to respond more fully to their citizens' preferences, whether expressed by voting with ballots or with feet. Accountability at the central level would let citizens across the country express their preferences with their ballots, knowing the taxes they paid to the central government were financing services delivered by it.

12 The Euro area is an important counterexample, but many people argue that its separation of fiscal from monetary policy is a serious flaw that may doom the arrangement.

Both levels would budget knowing they would need to cover their own costs, now and later, promoting sustainable fiscal policies.

In practice, however, spending responsibilities and revenue raising do not line up, and examinations of why not have generated an enormous literature.

Economies of Scale as a Public Good

The attraction of assigning some revenue raising to the central government, even when the programs those revenues will fund are sub-central, is evidently considerable. The reduced administrative and compliance costs of uniform national taxes on income and consumption, administered by one agency, have induced many countries, including Canada, to collect centrally at least some taxes that flow directly to sub-central governments.[13]

Realizing the public good of more efficient revenue collection does not, however, require formal, budgeted intergovernmental transfers. The remittances from Ottawa to the provinces in respect of personal, corporate or sales taxes attributable to activity in the provinces appear neither as a federal spending program nor as provincial transfer income, and we say no more about them. The transfers of interest here are not simple mechanical allocations of revenue: they are formal budgeted programs inspired by other goals.

Externalities

One such goal relates to public goods and services that generate benefits beyond the localities where they are provided – national transportation for example. Inter-jurisdictional spillover benefits mean that people want more investment in such goods and services than sub-central governments, responding to the costs and benefits within their jurisdictions alone, will provide.

As for negative externalities, central-government-imposed penalties, which would take the form of reductions in transfers otherwise payable, could respond to similar logic. Provinces can adversely affect each other in many ways, such as transboundary pollution, inadequate law enforcement that supports cross-border criminality, or violations of international agreements that trigger retaliation by foreign governments. Penalties levied by the central government could reduce negative externalities within the federation.

Redistribution, Equity, and Rights of Citizenship

Intergovernmental transfers also respond to the related notions that sub-central governments need resources to discharge their responsibilities and that citizens throughout the country have certain rights.[14] Law enforcement, for example, is often mainly managed locally, but has national

13 In Canada, further savings from centralized collection are likely possible. For example the Canada Revenue Agency has estimated that tax administration costs could be more than $500 million annually lower if Quebec's tax collection services were consolidated with federal ones, and this figure does not take into account the reduced compliance burden on Quebec taxpayers (Vailles 2015).

14 A classic pioneering investigation of redistribution within federations is Musgrave (1961). Boadway (2006) identifies three equity-related justifications for equalizing transfers, in the absence of interprovincial mobility. Regional fiscal equity aims to provide citizens of different regions but in otherwise similar economic circumstances similar public services for similar tax costs. Interregional insurance aims to insure sub-central governments against temporary shocks to their economies and capacities to generate tax revenues. National standards aim at uniformly high public services.

dimensions beyond spillovers. If people in one region are receiving inadequate protection, or suffering abuses from the police and the state, many voters will demand central government action, including financial support of the necessary infrastructure. If the alternative is direct central provision of functions in sub-central jurisdictions, subsidies for the sub-central governments are arguably better for a healthy federation.

Notions of citizenship rights can be quite expansive, getting into areas of "positive rights." Many Canadians identify certain government programs as coincident with citizenship. They therefore feel that Ottawa should finance them in whole or in part, to ensure that fiscal capacity to deliver those programs exists across the country, and as a lever to punish provinces that fail to meet the standard they feel is appropriate.

Arguments around regional equity carry weight. They found expression in the *Constitution Act, 1982*, which expresses commitment to ensuring that provinces have "sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation." Their principal formal expression is the Equalization program, but per capita block transfer programs such as the CHT and the CST also support fiscal equity in this sense.

The public finance literature that emphasizes regional and citizen equity tends to argue for centralization of taxation, especially income taxation. Mobile persons and businesses can more readily escape taxes levied by a sub-central jurisdiction; to escape central government taxes, they would need to emigrate. This dimmer view of the Tiebout model or the dynamic described by Brennan and Buchanan (1980) sees centralized collection as preventing what would otherwise be a "race to the bottom" in tax rates and redistributive programs.

Mitigating Harmful Migration

Another interpretation of the practice of subsidizing sub-central jurisdictions with lower-yielding tax bases is that such transfers reduce incentives for internal migration by businesses or workers seeking better packages of taxes and programs. In this view, actual or potential migration is economically inefficient – if, say, fiscal benefits differ from place to place because of unequal natural resource endowments, rather than reflecting the relative productivity of workers in the two regions (Boadway 2006).

A supporting argument rests on the observation that taxpayers move more readily among sub-central jurisdictions than across international borders. Without equalizing transfers, this internal mobility could make the distortionary costs of taxation higher at the sub-central level than at the central level. So economic efficiency would justify centralizing some taxation, combined with equalizing transfers to sub-central governments (Dahlby 2008).

Conclusive evidence of significant differences in tax distortions between central and sub-central governments in the absence of intergovernmental transfers has been elusive, however. Even if equalizing grants can reduce these distortions, moreover, they can also lower the perceived cost of taxation in recipient jurisdictions (Dahlby 2008, Dahlby and Ferede 2011). And if underestimation of the cost of raising additional revenues leads to higher sub-central taxes and spending, it will also lead to higher central taxes to finance the resulting higher equalization grants.[15]

15 Smart (2007) finds that equalizing grants induce higher average effective tax rates by equalization-receiving governments.

Recent Experience and Analysis

The experience of the very late 20th and early 21st centuries has prompted further thinking about the economics of federations and potential prescriptions.

One striking observation is the weak evidence for races to the bottom in tax rates and public services. Even internationally, where central fiscal authority is weak or non-existent, tax rates, public services and redistribution tended to increase in the advanced democracies after the Second World War, and have been quite stable since, while rising in developing countries. Whatever the effects of competition on tax rates, the overall impact of citizens voting at the ballot box and with their feet seems to have been convergence of taxation and spending around the levels established in the second half of the 20th century.[16] In Canada, accelerations and decelerations of spending at the provincial level seem easier to explain with reference to the fiscal condition of governments than trends up or down in the intensity of tax competition.

Another noteworthy development during the latter 20th and early 21st centuries is decentralization – in Canada, in the more advanced democracies,[17] and in many other parts of the world as well. Notwithstanding the economic and citizenship arguments for centralization, other considerations – including the benefits of sub-central accountability and interjurisdictional competition (as described by Brennan and Buchanan 1980, Oates 2005, and Chandra 2012) – seem to have forestalled any centralizing trend.[18]

As for feelings of national identity and their expression in positive rights of citizenship, there is no denying their power, and central governments often strive to bolster them. Yet citizens have multiple allegiances, and decentralization lets them put subnational identity first when enough of them wish it.

In Canada, differences in the regional intensity of citizens' national identity are persistent. The fact that only Quebec accepted a transfer of tax points rather than a full subsidy in the 1960s has already been mentioned. Many programs most Canadians would identify as national – such as the Canada Pension Plan, Employment Insurance, and medicare – do not work uniformly across the country. These differences are sometimes controversial: many see deviations from uniform treatment across the country as evidence that Ottawa is itself a tool for regionally based special interests to benefit themselves at the expense of Canadians elsewhere. Laudable or not, they indicate the limits of arguments based on rights of citizenship.

What about arguments for interregional transfers to mitigate economic shocks and inhibit inefficient migration? Recent literature underlines that

16 In OECD countries, public social spending-to-GDP increased from about 7.5 percent of GDP in 1960 to 22 percent in 2014 (see Figure 2 in OECD 2014).

17 OECD (2013) uses five measures of (de)centralization to compare countries and over time: the ratio of sub-central to general government spending; the ratio of sub-central own-revenue to general government revenue; the ratio of sub-central tax revenue to general government tax revenue; sub-central autonomy in setting tax bases and rates; and a measure of decisionmaking authority over education. The OECD measures indicate that OECD countries have generally decentralized over the past 20 years. Spending decentralization has outpaced revenue decentralization, however, resulting in higher intergovernmental transfers.

18 Contrasts in fiscal arrangements around the world, and changes over time, have supported a great deal of empirical work – but no consensus – on whether centralization or decentralization has any systematic effect on the size of government (Feld 2014).

regional insurance through open-ended transfers create moral hazard – among other things, reducing the incentive for sub-central governments to prepare for and adjust to economic shocks (Oates 2005). Boadway (2006) argues for providing inter-regional insurance through programs running on proper insurance principles.

Situations where fiscally induced migration into a resource-rich jurisdiction, or migration out of a resource-poor one, are economically inefficient are certainly plausible; so are situations where it is efficient. Many circumstances that let governments offer attractive fiscal packages – such as abundant natural resources, other geographic advantages, or efficiency in delivering services – are likely to correlate with good job opportunities, so differences in net fiscal benefits do not necessarily induce inefficient migration.

Some dysfunctions in federations have also spurred new thinking. Inside Canada, the persistence of regional disparities, and evidence that some intergovernmental grants create problematic incentives for recipients, showed that public choice considerations matter (see, for example, Courchene 1998). Problematic behaviour by sub-central governments, in Argentina and Brazil for example (Tanzi 1996), have directed fresh attention to the incentives intergovernmental transfers create, and negative externalities from them. We would note that much of the provincial and local infrastructure spending supported by federal transfers in Canada, on public transit for example, does not provide national-scale public goods or mitigate interprovincial externalities. A more straightforward explanation would be regional vote-buying.

In particular, recent literature highlights the importance of "hard" versus "soft" budget constraints in fostering sustainable fiscal policy (Oates 2005). Decentralization with open-ended transfers leads recipients to expect the provider of transfers to finance excesses, either because it has formally committed to do so, or because commitments not to do so will prove practically impossible to keep. If intergovernmental grants permit bailouts, the temptation will be to expand public programs beyond levels that reflect public preferences or are sustainable over time (Rodden 2002).[19]

A key condition of efficiency and sustainability is that potential lenders must have a clear view of the creditworthiness of potential borrowers. One criterion is the ability of sub-central jurisdictions to raise the revenues they need to finance their expenditures. A second is intergovernmental transfers that are stable and consistent with budgetary discipline, rather than prone to ad hoc adjustments when a sub-central jurisdiction gets into trouble. At the time of writing, the problems the European Union is having with Greece demonstrate the dangers of a unit within a larger system acting on the assumption that it can force a bailout.

The Outlook for Federal and Provincial Revenue and Spending

The philosophical cross-currents just discussed will continue to inform the Canadian debate within the broader context of economic forces that affect the various levels of government differently. On current evidence, the biggest challenge in the coming decades will be the fiscal implications of demographic change.

19 For a discussion of this problem as it relates to healthcare-related transfers specifically, see Crivelli et al. (2010).

Slower Revenue Growth

Looking first at revenue, a country's workforce is a key determinant of its capacity to produce goods and services. Absent tax changes, total output and spending tend to affect government revenues proportionately (Drummond 2011). With the babyboomers leaving the workforce, and their descendants and immigrants barely replacing them, growth of GDP and the tax base is set to slow.

Over the last 35 years, Canada has seen an annual increase in the number of individuals of workforce age (18-64) of around 1.2 percent. Over the next 15 years, that growth rate will be only around 0.1 percent annually (Figure 7).[20]

Upward Pressure on Spending

Demography also affects government spending. Publicly funded pensions, old-age transfers and healthcare will grow disproportionately as the boomers age. Publicly funded healthcare is strongly geared to age (CIHI 2014), and the growing importance of publicly funded drug programs, which most provinces direct mainly toward seniors, may intensify that pressure. The population aged 65 and up relative to that of working age Canadians is set to increase from about one senior per four potential workers today to around one senior per three potential workers in 10 years' time and one senior for every 2.5 workers in 20 years (Figure 8). What is more, the youth dependency ratio – those aged 0-17 relative to the working-age population – is no longer declining. So the relief recently provided by relative decline in the young population – on which governments spend less lavishly in any event – will not continue.

Quantifying Demographic Pressures on Government Budgets

A demographic model with middle-of-the-road assumptions for fertility, immigration and cost inflation produces some startling results for age-sensitive government spending relative to gross domestic product (GDP).[21] Our baseline shows age-sensitive spending in Canada rising from 13.0 percent of GDP in 2014 to 15.6 percent in 2035, and 20.4 percent in 2065 (Figure 9). Publicly funded healthcare, projected to rise from about 7.3 percent of GDP today to around 9.8 percent in 2035, and 13.9 percent in 2065, is the major driver of this increase.

Ottawa will need to manage a temporary rise in the cost of seniors' benefits, but that is the extent of direct federal exposure. Provincial responsibility for healthcare means that the fiscal impact of demographic aging will fall mainly on them.[22]

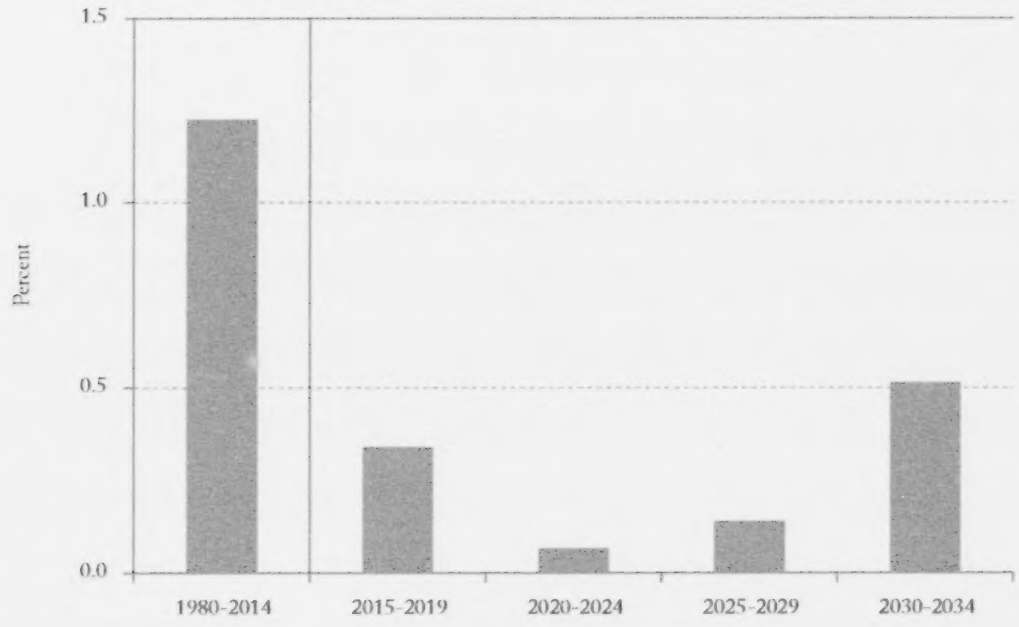
If we think of current spending on demographically sensitive programs and current taxes to finance them as two sides of an implicit political bargain, we can quantify the higher future costs of these programs as an implicit liability. The present value of the higher taxes needed to cover their incremental cost over a 50-year span – roughly the life expectancy of the average-age Canadian – is

20 Immigration is not a solution to demographic woes (see Robson and Banerjee 2009). Some mitigating factors include the possibility of labour force participation rates rising to help offset the declining workforce population growth. Among older workers, retirement ages have been increasing in recent years as babyboomers choose to work a little longer than the traditional retirement age (Hicks 2012). That said, some damping affects of slower labour-force growth seem inevitable.

21 For detailed information on the assumptions made here, see Busby, Robson and Jacobs (2014).

22 A number of research studies have come to similar overall conclusions; for example, see Drummond (2011) and Dodge and Dion (2011).

Figure 7: Average Annual Growth of Working – Age Population (Age 18-64)



Source: Authors' calculations.

like a notional fund Canada would need to have set aside to cover the cost of this implicit bargain. That liability is almost entirely provincial: some $108,000 per person, versus $12,000 per person for Ottawa (Table 1).

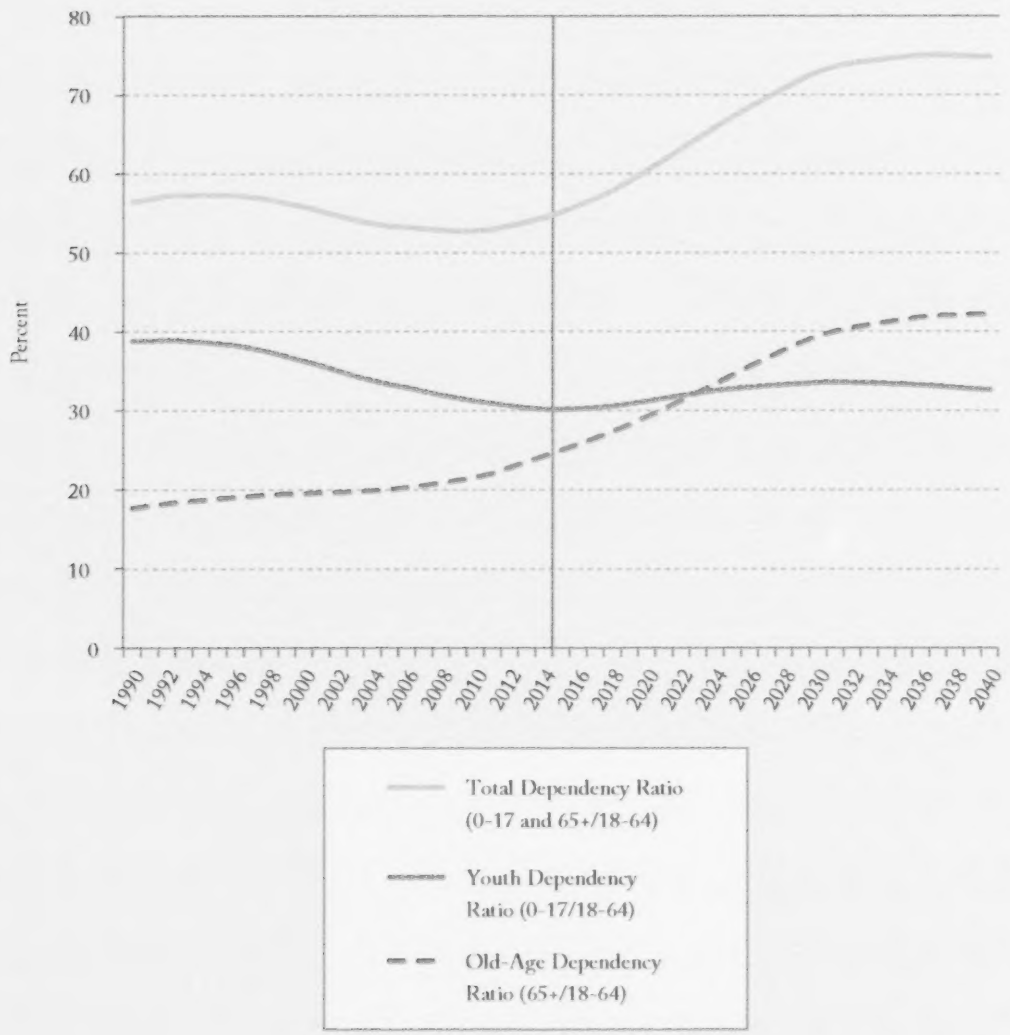
Responding to Fiscal Pressure

How might provinces react to this pressure? A review of the options shows why bigger intergovernmental transfers will be attractive for them, but problematic for the country.

Provincial Fiscal Consolidation

On recent evidence, deficits are a politically acceptable way for many provinces to avoid addressing hard budget constraints. At current debt levels, provinces have worse credit ratings than Ottawa, but seem no less able to access credit markets (Table 2). Indeed the most recent release of the National Balance Sheet Accounts (first quarter of 2015) highlighted the fact that, by that measure, the aggregate debt of PTL governments has surpassed that of the federal government for the first time.

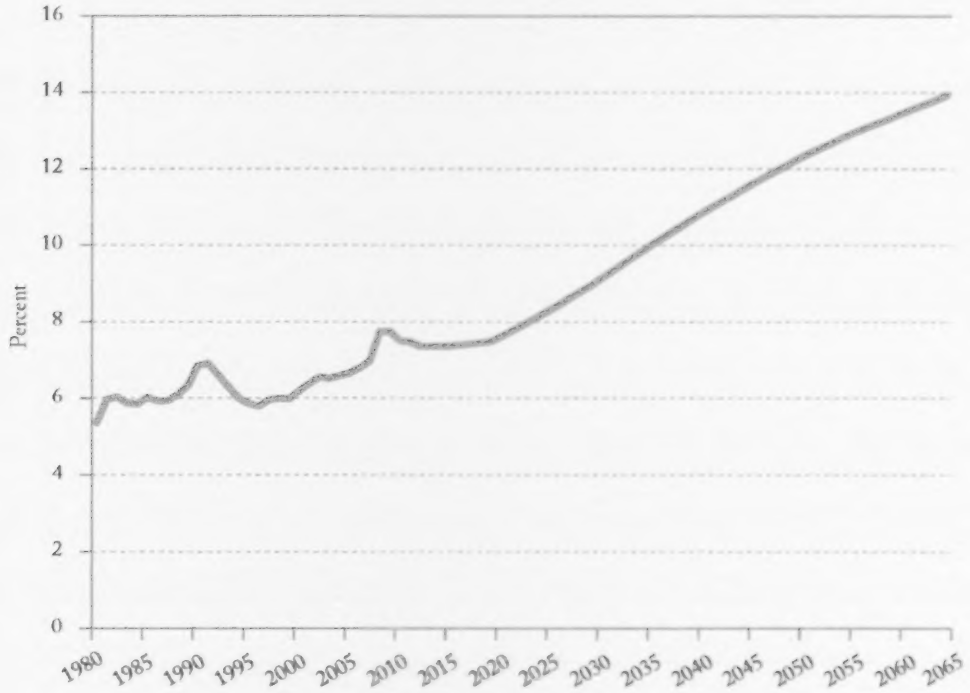
Figure 8: Demographic Dependency Ratios, 1990-2040



Source: Authors' calculations.

Borrowing, however, is not a feasible approach to the long-term fiscal challenge. Demographic pressure will persist for decades, and letting the implicit liability become funded debt would mean mounting interest payments, and likely exhaust the willingness of potential lenders. More durable budget management will rely on a mix of tax increases, spending control, and in some areas, potential prefunding of programs that involves a bit of both.

Figure 9: Government Health Spending as a Share of GDP, Historical and Projected, 1981-2065



Source: Authors' calculations.

Table 1: Implicit Liabilities from Age-Sensitive Government Programs

	Implicit Liabilities by Type						
	Health	**Education**	**Elderly Benefits**	**Child/Family Benefits**	**All Programs**	**All Programs Relative to GDP (2014)**	**All Programs per Person**
	$ Billions					***Percent***	***$***
Provincial/ Territorial	3281.1	552.5	19.2	-22.0	3831.1	199	108,100
Federal	0.0	-12.1	461.0	-21.1	427.8	22	12,100
Canada	3281.4	540.4	480.2	-43.1	4258.9	220	120,200

Source: Authors' calculations. Totals may not add due to rounding.

Table 2: Provincial and Federal Gross Debt, Assets, and Accumulated Deficits as at March 31, 2014

Jurisdiction	Gross Debt	Financial and Tangible Capital Assets	Accumulated Deficits
	Percent of GDP		
Newfoundland and Labrador	32.2	18.4	13.8
Prince Edward Island	25.6	6.4	19.2
Nova Scotia	39.4	16.0	23.4
New Brunswick	34.9	24.6	10.3
Quebec	54.3	21.3	33.0
Ontario	45.0	19.6	25.4
Manitoba	37.4	26.6	10.8
Saskatchewan	14.5	18.7	-4.2
Alberta	7.0	22.9	-15.9
British Columbia	27.0	27.9	-0.9
Federal	47.0	14.7	32.3

Source: Compilation by Quebec (2015).

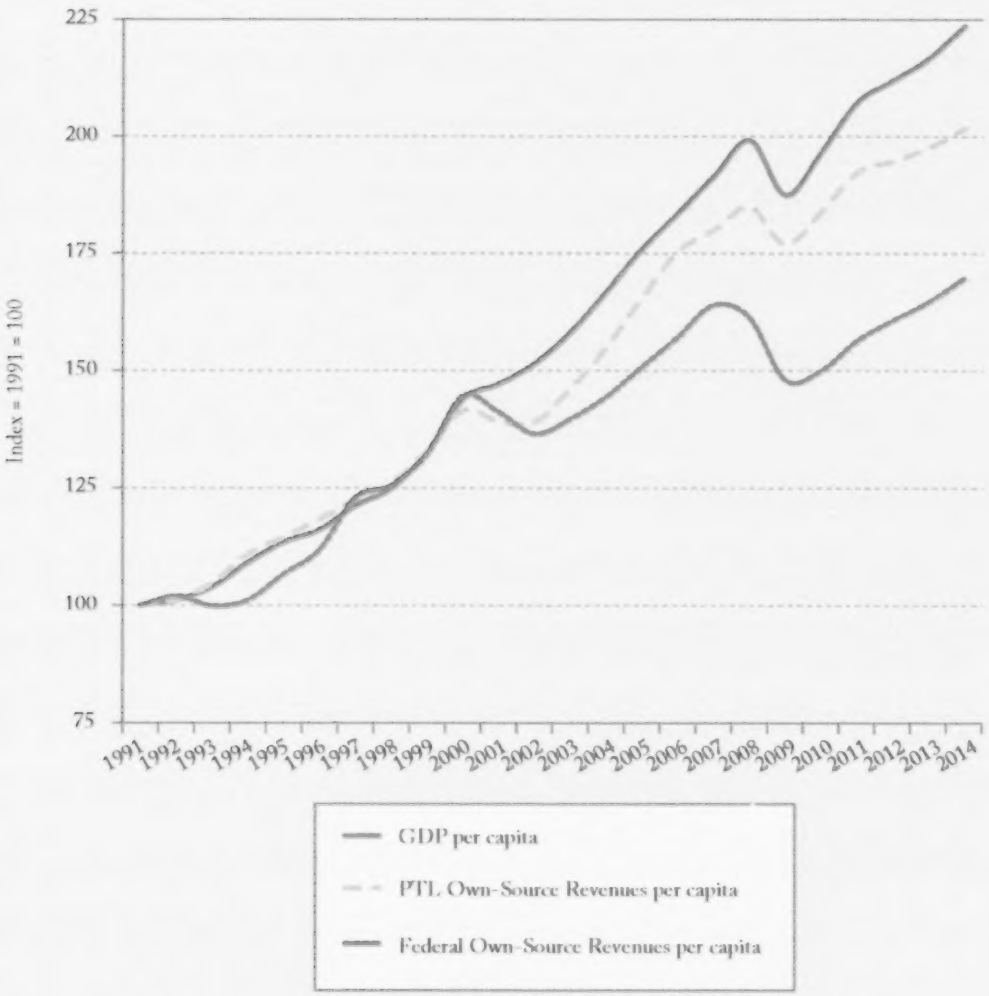
Provincial Tax Increases

We have noted already that provinces have increased their share of spending more than their share of revenue since the late 20th century. Provinces have access to the same major revenue sources as Ottawa, as well as exclusive jurisdiction over such sources as resource royalties, gaming and liquor profits, and property taxes. Recent slower growth of federal revenues – especially due to consumption tax cuts and slow growing employment insurance premiums – suggests that provinces could raise more without proportionate increases in total taxes relative to GDP (Figure 10). How might they do so?

In recent years, a politically attractive option to generate incremental provincial revenues has been to raise personal income tax rates on high income earners.[23] Starting with Nova Scotia in 2010, six

23 British Columbia also raised its general corporate income tax rates from 10 to 11 percent in 2013, while Ontario delayed in 2012 a scheduled 1.5 percent corporate tax rate reduction over two years, from 11.5 to 10 percent, until the return to a balanced budget.

Figure 10: Relative Growth of Federal and PTL Own-Sources Revenue and GDP, 1991-2014



Sources: Government Finance Statistics (Statistics Canada 2015). Data adjusted to take into account the effect of the Quebec tax abatement; authors' calculations.

Table 3: Recent Provincial Tax Increases on Top Earners

	Year of Tax Change	Top Income Threshold *($)*	Provincial Tax Rate *(percent change)*	Combined Federal/ Provincial Rate *(percent)*
Nova Scotia	2010	150,000*	21.00 (+3.50)	50.00
New Brunswick	2015	150,000 250,000	21.00 (+3.16) 25.75 (+7.91)	50.00 54.75
Quebec	2013	250,000	25.75 (+1.75)	49.97
Ontario	2012 2013	500,000 509,000	18.97 (+1.56) 20.53 (+1.56)	47.97 49.53
Ontario	2014	150,000* 220,000*	18.97 (+1.56) 20.53 (+3.12)	47.97 49.53
Alberta	2015	125,000 150,000 200,000 300,000	12.00 (+2.00) 13.00 (+3.00) 14.00 (+4.00) 15.00 (+5.00)	41.00 42.00 43.00 44.00
British Columbia**	2014	150,000	16.80 (+2.10)	45.80

Notes:
* = not indexed to inflation.
** = The 2.1 percent surtax is due for elimination in 2016.

provinces have increased their top tax rates, with Quebec, Ontario, and Nova Scotia now having combined federal/provincial top tax rates rounding to 50 percent, and New Brunswick's rounding to 55 percent (Table 3).

Shifting more of the tax burden to a relatively small number of people may be politically attractive, but it does not necessarily yield the desired revenue. Responsiveness of taxpayers to tax changes has been estimated many times in Canadian and international studies, with the highest sensitivity found among top earners (Box 1).

In Box 1, we explore the revenue impact of Ontario's high-earner tax increases since 2012. If taxpayers did not change their behaviour, the changes might have yielded an additional $1.2 billion in 2015. Allowing for taxpayers responses, however, reduces these gains to only $0.6 billion.[24]

24 This estimate is consistent with recent experience in the United Kingdom, where the government raised the top tax rate from 40 to 50 percent in 2010, only to lower it to 45 percent three years later, stating that the 50 percent rate had raised "next to nothing" in fresh tax revenues (UK Chancellor George Osborne quoted in Seely 2014).

Box 1: High-Income Earners' Responsiveness to Personal Income Tax Rate Increases

Taxpayers, especially those already facing high personal tax rates, tend to respond to tax-rate changes. Rate hikes may lead taxpayers to reduce their paid work, take compensation in less heavily taxed forms, adjust the timing of transactions, relocate, or use trusts located outside the province. All such changes will tend to reduce tax receipts.

A common measure of the size of these responses is the "elasticity of taxable income" (ETI). The ETI estimates the change in taxable income resulting from a 1 percent change in a taxpayer's net-of-tax earnings. One survey of international academic studies (Canada 2010) finds a median ETI of 0.40, implying that a 10 percent decrease in net-of-tax earnings reduces reported taxable income by 4 percent. Sillamaa and Veall (2001) studied the response of Canadian taxpayers to the 1988 federal tax reform and found an ETI of 0.25 for the entire working-age population, but an EYI of 1.30 for high-income earners. Milligan and Smart (2014) find that the ETI at the provincial level is large for the top 1 percent of income earners (their preferred estimate is 0.69); Canada (2010) finds an ETI ranging from 0.62 to 072 for the highest income group.

Box Table 1 shows estimates of the cumulative revenue impact of behavioural responses to top tax rates changes in Ontario since 2012. We adopt an ETI of 0.30 for taxpayers with taxable income in the $150,000-to-220,000 range, and an ETI of 0.70 for taxpayers with taxable income above $220,000 – values broadly consistent with Canada (2010) and recent Canadian literature.

Box Table 1: Simulating the Revenue Yield from Recent Ontario Tax Rate Increases, With and Without Behavioural Response, 2015

	Jurisdiction	Impact of Recent Top Tax Rate Increases on Ontario High-Income Taxfilers
		$ Billion
Mechanical Tax Revenue Yield	Ontario	1.2
	Federal	0.0
	Total	1.2
Estimated Impact of Taxpayers' Behavioural Response on Tax Receipts	Ontario	-0.6
	Federal	-0.7
	Total	-1.3
Net Tax Revenue Yield	Ontario	0.6
	Federal	-0.7
	Total	-0.1

Source and methodology: Simulations performed using Statistics Canada's SPSD/M, with ETI of 0.3 and 0.7 as described in text.

Moreover, erosion of the national tax base by provincial rate increases affects federal revenues – a negative externality. The recent Ontario hikes, we estimate, cost Ottawa about $0.7 billion. Since the federal losses exceed the provincial gains, the hikes are a revenue loser on a national scale.

Generally speaking, a consumption tax, especially a value-added tax like the Harmonized Sales Tax (HST), has less economically harmful effects on savings, personal and business investment decisions, migration of labour and firms, and work decisions, than personal or corporate income taxes. For provinces, the lowest-cost way to increase revenues from their own sources would be to tax consumption.[25]

The recent evolution of consumption taxes and personal/corporate income taxes reveals the effect of the 2 percent GST cut at the federal level (Figure 11). Federal and provincial income tax revenues have grown pretty much in line with GDP in the last 25 years, but federal consumption taxes have grown less. So the provinces could occupy room vacated by Ottawa. Although measures to tax high income earners have had a higher profile, provinces have made some recent moves in this direction. Quebec raised its value-added tax by 1 percent in both 2011 and 2012. Manitoba increased its provincial sales tax by 1 percent in 2013. In 2014, Nova Scotia decided not to proceed with previously announced rate cuts to its HST. Newfoundland and Labrador has just announced a 2-percentage-point hike in its HST, effective January 2016. If Ottawa reduced its presence in the consumption tax field further, provincial opportunity in this area would grow.

Because they affect behavioural less, consumption tax increases have the key advantage of bringing in amounts closer to what static calculations – that is, calculations assuming no behavioural impact – predict. If economic activity tips more toward consumption and away from investment as the population ages, moreover, consumption taxes will rest on a relatively robust base.

The fact that consumption taxes can be more politically awkward has a positive side. Taxpayers may require greater accountability for extra consumption tax revenues raised. So they may be the revenue source likelier to induce needed spending reforms.

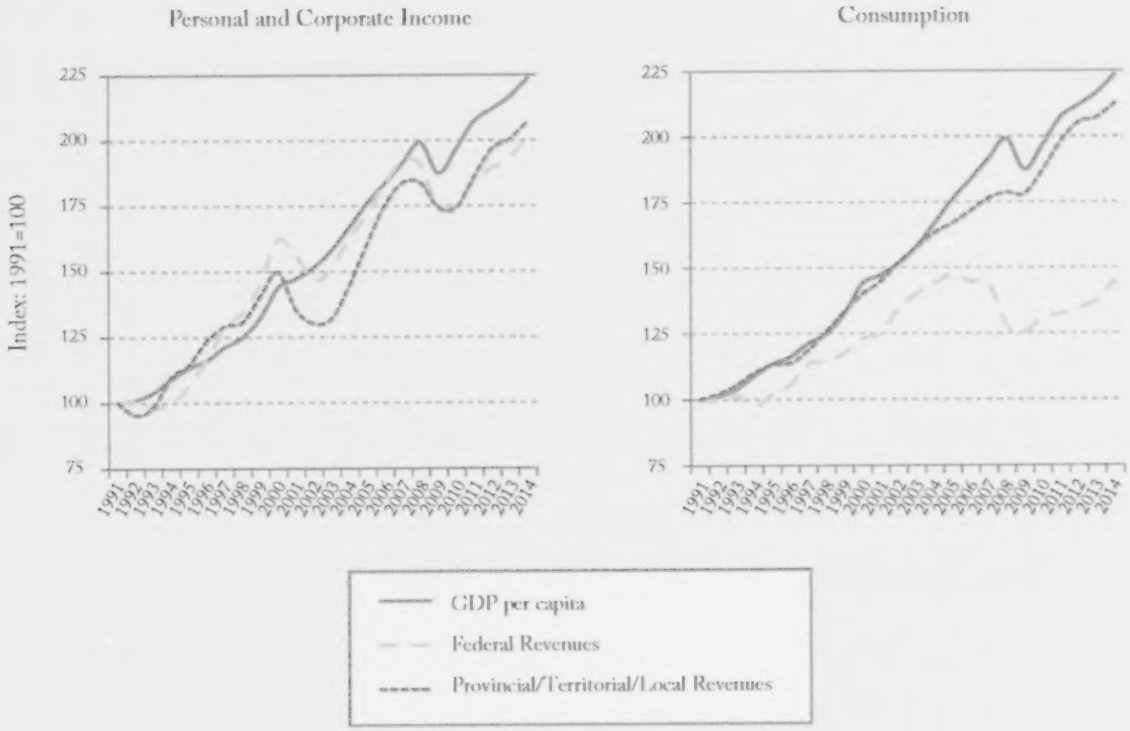
Tighter Spending Control

Efforts to contain spending at every level of government have been so high profile – not least in spring budgets – and so well discussed that reviewing them at length in this paper would add more length than enlightenment. The key point worth underlining is familiar: containing spending is hard because of the numbers and focused political energy of transfer recipients, and – especially at the provincial level – the power of governments' direct employees and providers of publicly funded services such as health and education.

The greater political power of groups that benefit from government spending, compared to that of current and future taxpayers, makes spending restraint easier when the hard tradeoffs are relatively immediate and easy to demonstrate. Those circumstances tend to apply when what previously appeared a soft budget constraint, the

25 For example, recent estimates of marginal costs of public funds for provinces show that raising an additional dollar of corporate tax revenue today may end up costing from an extra $1.25 in the long run in Manitoba to a cost so large in some other provinces like Ontario that a small increase in corporate tax rates would be counterproductive, yielding lower revenues. The long-term extra cost of raising another dollar of personal income tax today in various provinces range from $0.45 in Alberta to $2.45 in Quebec – over and above the dollar raised – while that cost ranges from only $0.13 to $0.21 (excluding Alberta) for an extra dollar of value-added sales tax on consumption (Dahlby and Ferede 2011).

Figure 11: Relative Growth of Federal and Provincial Taxes on Incomes and Consumption and GDP, 1991-2014



Sources: Government Finance Statistics (Statistics Canada 2015). Data adjusted to take into account the effect of the Quebec tax abatement; authors' calculations.

need for a bottom line that attracts credit, becomes hard – as was the case in Saskatchewan in the 1990s, for example.

Sustainable Social Insurance Reform

Provinces could respond to demographic pressure by partially pre-funding some age-sensitive social insurance programs. An attractive model is the reforms that partially pre-funded the CPP and QPP in the late 1990s to stabilize their costs over time. Those reforms combined near-term spending cuts with contribution hikes larger than needed to pay the current costs of the program. The high profile of the projections determining whether the

new contribution rate was sustainable has likely mitigated the pressure for benefit enrichment that always affects such programs.

Analogous changes to publicly supported drug programs or retirement and long-term care facilities would make potential future recipients pay extra in the near term, with funds not needed for current program expenditures flowing into an investment account. Future drawdowns from that account to pay for the relevant services would supplement future tax or premium revenue, limiting the impact of aging-related costs on the ensuing generations of taxpayers (Busby and Robson 2011). Such reforms would be challenging, but the C/QPP reforms, which were spurred by the prospect of having inadequate funding to pay benefits in a few years' time, show that a suitably hard budget constraint can make them happen.

Federal Intergovernmental Transfers

For provinces, the soft budget constraint offered by further hikes in intergovernmental transfers will be tempting. Indeed, the growing importance of federal transfers in most provincial budgets (Table 4) has likely increased their focus on Ottawa as a possible solution to their fiscal challenges.

At a given moment, the formulas for these transfers may make them look firm – that is, provinces may appear to face hard budget constraints that oblige them to manage revenues and spending without a federal bailout. But the many changes in the structure and size of these transfers over time likely softens the provinces' perceived budget constraint.

Provincial governments choose the gap between how much they spend and how much they collect. The more federal transfers appear to respond to provincial fiscal pressures, the weaker are the incentives for provincial governments to raise own-source revenues or manage expenditures efficiently.[26] And the stronger are the incentives to deflect blame for shortcomings in their programs, or unhappiness about the taxes they charge, onto Ottawa, and to devote time and energy they should devote to improving services to lobbying for bigger federal transfers instead.

It would be perverse if transfers widely seen as helping provinces perform their functions were actually undermining the provincial autonomy essential for a healthy federation. As Table 4 shows, however, major federal cash transfers make up two-fifths of the budget of many provinces, and are nowhere less than one-seventh. These average levels tell us nothing directly about the changes at the margin that affect decisions, but it is reasonable to worry that they induce provincial governments to direct too much attention toward Ottawa, at the expense of their own taxpayers and citizens.

In this context, proposals that Ottawa should establish a new pharmacare program to subsidize, or even replace, provincial drug programs look problematic on several grounds. One version envisions federal pharmacare replacing all drug benefits currently provided by provinces to citizens, and supplanting all employer-related drug benefits, including the relatively expensive drug benefits of provincial government employees.[27] The desirability of integrating drug programs better with doctor, hospital and other provincially funded

26 Provincial government officials who object to this view should review their own recent experience with recipients of their transfers. Hospitals are a case in point. If hospitals are able, as they often have been, to over-shoot budget targets and get bailed out by provincial transfers, they will not manage their budgets as tightly as they would if deficits directly affected their resources in subsequent years. Soft budget constraints are antithetical to good management wherever they exist.

27 Morgan et al. (2015).

Table 4: Major Federal Transfers and Total Revenue by Province, 2003/04 and 2013/14

	Federal Cash Transfers (*$ millions*)			Total Revenues (*$ millions*)			Federal Cash as Share of Total Revenue (*percent*)		
	2003/04	2013/14	change	2003/04	2013/14	change	2003/04	2013/14	change
Newfoundland and Labrador	1,543	1,136	-406	4,194	7,246	3,052	37	16	-21
Prince Edward Island	387	623	236	1,021	1,592	571	38	39	1
Nova Scotia	2,024	3,273	1,248	5,951	8,792	2,841	34	37	3
New Brunswick	1,918	2,875	957	5,512	7,764	2,252	35	37	2
Quebec*	12,820	22,280	9,460	56,953	92,904	35,951	23	24	1
Ontario	9,894	22,277	12,383	74,549	115,911	41,362	13	19	6
Manitoba	2,716	3,823	1,107	8,491	14,464	5,973	32	26	-6
Saskatchewan	1,033	1,628	595	6,558	11,463	4,905	16	14	-2
Alberta	2,926	6,729	3,803	25,887	45,293	19,406	11	15	4
British Columbia	3,621	7,502	3,881	29,325	43,728	14,403	12	17	5
Total Provinces	38,882	72,145	33,263	218,441	349,157	130,715	18	21	3

* Amounts for Quebec adjusted to take into account the effect of the Quebec tax abatement: federal cash transfers to Quebec are increased by the value of federal income tax abated under the Alternative Payments for Standing Programs (13.5 tax points), whereas Quebec tax revenues are reduced by the same amount plus an additional 3 percentage points for the discontinued Youth Allowances Program.

Sources: Fiscal Reference Tables 2014; authors' calculations.

services, makes a comprehensive federal takeover undesirable. Moreover, the immediate impact of a relatively fiscally healthy federal government underwriting drug costs would surely be to increase spending, rather than to support the discipline of provinces facing a harder budget constraint.

Even if federal taxes are less damaging than provincial taxes, moreover, the federal taxes that finance federal transfers are damaging, and therefore create negative externalities for provincial governments. Suppose Ottawa hiked high-income tax rates as Ontario has just done. That would shrink the relevant tax base across the country, hurting provincial revenues. And some responses to federal tax hikes are more damaging to the country than responses to provincial hikes, since movement of income, and possibly taxable entities, abroad is a complete loss to Canada, with no offset as occurs when activity moves from one province to another.

The problems created by soft provincial budget constraints may be worse in the future than what Canadians have experienced since the mid-twentieth century. The provinces that will experience above-average stresses from ageing tend to be the provinces that already have larger debt-to-GDP ratios. A heavily indebted province, especially one that is small, might expect Ottawa to step in if its access to credit markets disappeared. If a financing crisis actually occurred, however, the federal government would face a horrendous choice. It could allow a default, risking contagion to other fiscally stressed provinces. Or it could bail the province out, setting a terrible precedent, and potentially undermining even its own credit access, since a bailout of Quebec or Ontario would be much harder to manage than that of a small province. Far better is to ensure that each province sees its budget constraints as hard, and manages its taxes, costs and social-insurance programs to ensure that they are sustainable without additional federal help.

Considerations and Conclusions

The striking changes in the practice and theory of fiscal federalism over time provide useful context for considering how spending, taxation and transfers among Canadian governments may evolve in the future. The insights from public economics about different transfers help in understanding their impact, but past changes from unconditional to conditional and back to unconditional grants reveal the importance of circumstances, and the limits of normative guidance. In our view, the generally high standard of public services in the Canadian federation, even as federal grants have become less conditional, suggests that Canada would be well served by reforms that give provinces more capacity to raise their own revenues – notably by relying more on consumption taxes.

To the extent that different packages of taxation and spending in different provinces reflect different preferences among their citizens, the case for federal intervention is weakened. Competition among provinces to offer – or not to offer – different packages of taxes and public programs is a strength of a federation, not a problem Ottawa needs to offset. Intervening to reduce the tax-cost of a given program in one province at the expense of others that are charging less relative to the value they are providing their citizens reduces the incentive for each province to provide cost-effective programs.

A focus on improving decision-making at each level of government directs attention away from further increases in transfers from Ottawa to the provinces. Measures to more closely align the revenue-raising and spending powers of governments at each level seem a more promising route to a healthy Canadian federation in the future.

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